The Moscow Financial Services Cluster

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HARVARD | BUSINESS | SCHOOL

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1.0 Executive Summary

Russia is a nation with great potential but also great challenges. Endowed with abundant natural resources, particularly oil and gas, Russia has relied heavily on energy exports to grow its economy. Given a long history of authoritarian governments, Russia continues to struggle with burdensome regulations and the dominance of state-owned enterprises (SOEs). Russia's economy has grown rapidly in the last decade, aided by devaluation of ruble, high commodity prices and political stability. As a result, Russia significantly reduced the gap in GDP per capita with OECD countries, achieved an upper-middle income status, became the world's ninth-largest economy, and greatly increased its foreign exchange reserves. Though the recent financial crisis severely impacted Russia, its growth has rebounded to near pre-crisis levels.

While macroeconomic conditions improved, the social infrastructure and political institutions have deteriorated, and corruption remains a serious and growing problem. The competitiveness of Russia's economy is decidedly weak as the national business environment has yet to significantly improve, clusters remain concentrated in resource industries, and the sophistication of the business community fails to reflect Russia's robust economic performance.

Centered in Moscow, Russia's financial services cluster is underdeveloped. A high savings rate and flow of petrodollars provide ample liquidity, but the financial system fails to translate it into capital to stimulate growth. This systemic failure stems from low competition, the underdevelopement of critical subsectors, a general distrust of banks and other financial intermediaries, as well as corruption and weak legal institutions.

The future success of this cluster, which is critical to improving Russia's competitiveness, will require a clear strategic positioning (e.g. regional financial center for the former USSR countries), enhanced rule of law, decreased role of SOEs, and targeted measures to develop sub-sectors providing long-term capital such as pension funds, asset management, and life insurance.

2.0 Russia: Competitiveness

2.1 Russia at a Glance

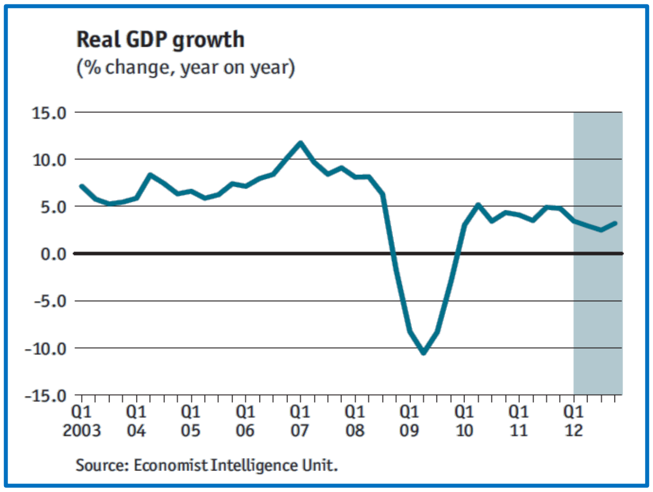
Russia is the world's largest country by landmass with over 17 million square kilometers across northern Asia. Though it is nearly twice the size of the United States, Russia's population is under half of the U.S. population at approximately 140 million people (CIA-WF, 2012). Russian is the official language but 27 additional languages are spoken throughout Russia. The largest religious denomination is Russian Christian Orthodox (15-20%), followed by Muslim (10-15%), and other Christian (2%), though a majority of the population is religiously unaffiliated due to Soviet rule. (CIA-WF, 2012)

Russia has a long history of authoritarian governments. The tsars ruled feudal Russia from the mid-sixteenth century through the period of Russian imperialism of the eighteenth and nineteenth centuries until the Bolshevik Revolution in 1917. For most of the 20th century, Russia was ruled by the Union of Soviet Socialist Republics (USSR), a highly-centralized communist regime. Today, the Russia Federation is a federal semi-presidential republic governing 46 provinces, 21 republics, 4 okrugs, 2 federal cities, and 1 autonomous oblast. (CIA-WF, 2012)

2.2 Economic Performance

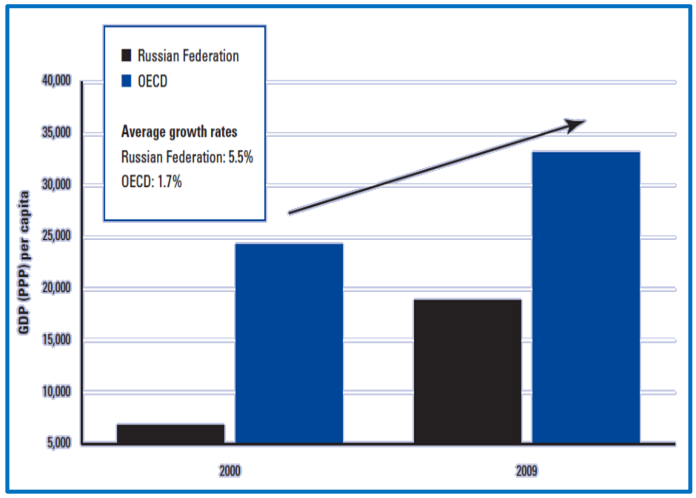
Russia has a large and growing economy. Russia's GDP (PPP) is $2.2 trillion and it experienced 4.0% growth in 2010 with a 5-year compound annual growth 3.4%. (EIU, 2012) While significantly affected by the recent financial crisis, Russia's GDP was able to make a nearly-complete recovery. (See Figure 1.) As shown in Figure 2, Russia's economy has grown faster than the OECD average, allowing the Russian GDP per capita to grow from a tiny fraction of the OECD average in 2000 to about half of the OECD average today ($15,837). (WEF, 2011) Unemployment is 7.6% and inflation (CPI) is 6.9%. Russia's FDI inflow is $41.2 billion and its public debt is relatively low at 11.7% of GDP. (WEF, 2011)

Figure 1. Real GDP Growth in Russia



Source: EIU, 2011

Figure 2. GDP per capita



Source: WEF, 2011

However labor productivity in Russia still lags far behind the OECD level, in large part due to poor infrastructure and sectors of economy that are not exposed to global competition. Termed "supporting sectors" by the WEF, they include business services, construction, real estate, hospitality, etc. (WEF, 2011). Innovation capacity is above BIC countries (Brazil, India and China), but output is weak and not expanding as fast. (IFD, 2010-11)

2.3 Russian Competitiveness

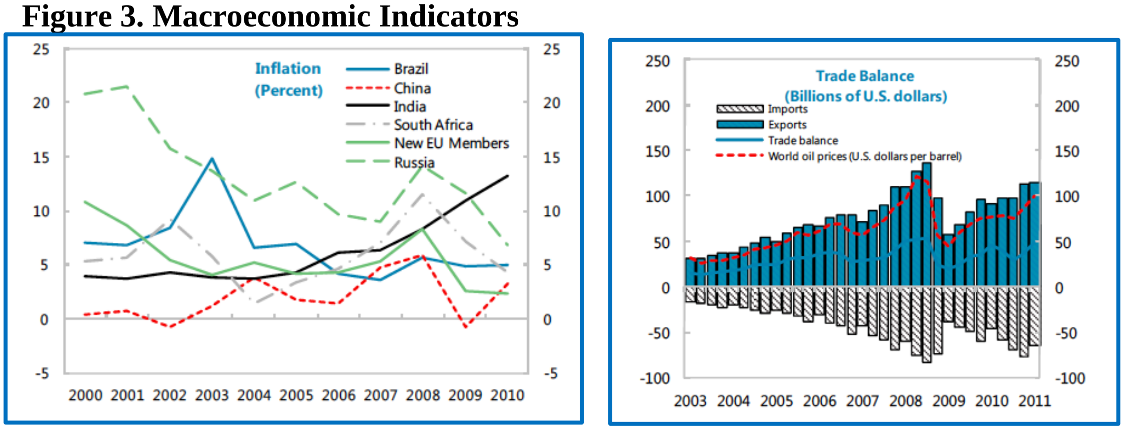
2.3.1 Endowments

Russia is a natural resource powerhouse. It has a vast array of natural resources, particularly oil, gas, coal, and precious metals as well as abundant agricultural land, forests, and water. In terms of oil and gas, Russia controls 5.6% and 23.7% of the world's resources, respectively (at the end of 2009), making the country the biggest exporter of mineral fuels, oils, and distillation products in the world (in 2009) with a market share of 10.6%. But Russia's wealth in natural resources is not limited to hydrocarbons. The country also controls 8.4% of the world's water reserves, 8.1% of its arable land, and 23% of its forest cover. (WEF, 2011)

2.3.2 Macroeconomic Competitiveness: Macroeconomic Policy

Over the past 12 years, Russia has succeeded in reducing inflation from above 20% to 7%, curbing unemployment, significantly reducing public debt and building foreign currency reserves. However most of the gains were achieved due to high commodity prices, and if oil prices drop then Russia's current account and budget will significantly deteriorate. The Institute for Strategy and Competitiveness ranking reflects the improvements, as Russia gained 19 positions to #50 in 2011 (being ranked #1 in government surplus and debt, and #66 in inflation), which is still below its 36th place by PPP-adjusted GDP per capita. (ISC, 2011)

Figure 3. Macroeconomic Indicators



Sources: IMF Country Report No.11/294 (2011)

2.3.3 Macroeconomic Competitiveness: Social Infrastructure & Political Institutions (SIPI)

Russia's SIPI rank is 65th, with relatively more favorable human development (#51) and with political institutions and rule of law both very low and decreasing (ISC, 2011). The World Economic Forum's analysis of business environment in Russia reveals that corruption, crime and theft, access to financing, and the labor force work ethic have worsened in the between 2005 and 2011. However, Russia has also achieved sizable progress in areas such as tax regulations, efficiency of government bureaucracy, and stability of policy. (WEF, 2011)

Corruption is a perceived as the main problem for doing business and the extraordinary cost of road building is indicative of the scale of the problem. In China, the government pays

$1.3 million per kilometer, while the Russian government pays an astonishing $10.5 million per kilometer. (WEF, 2011) Corruption is especially challenging for financial system development as it brings money laundering, cash payments and exports of capital. Finance professionals put improvement in the rule of law on top of their list of desired changes. (Oliver Wyman, 2011)

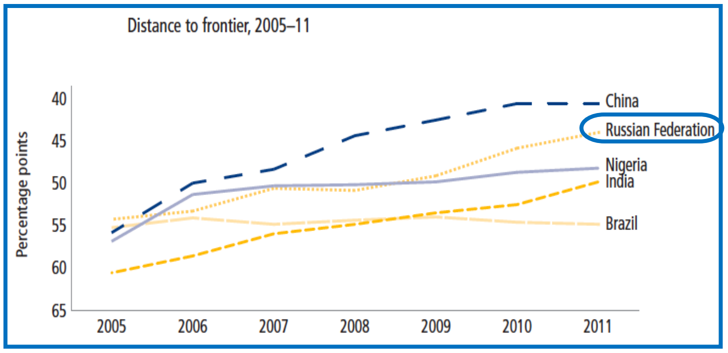
Education: Russia's education system is one of the country's strengths, however, its quality seems to be eroding (WEF 2011). Russia ranks 25th out of 139 economies on the indicator measuring the quantity of education, far ahead of Brazil (51st), China (96th), and India (108th) and also has one of the highest shares of workers with a tertiary education at 51%: behind only the USA (60%) and ahead of Australia (35%), Finland 34%, Germany (24%), and Poland (20%) (WEF, 2011). However, quality leaves much to be desired. According to the Programme for International Student Assessment (PISA) tests on both mathematics and science, Russian 15-year-old students perform below the OECD average. Across all disciplines, Russia places below both Poland and Turkey. Tertiary education is also weak, as Russia is home to only a few of the world's leading universities.

2.3.4 Microeconomic Competitiveness: National Business Environment

Russia ranks 67th in the ISC ranking for national business environment, 6 position down from its 2001 rank. While factor conditions were relatively more favorable (#57), especially regarding communication (#38), and innovation infrastructure (#48), Russia scores low on demand conditions (#66), supporting and related industries (#66), and context for strategy and rivalry (#70) (ISC, 2012).

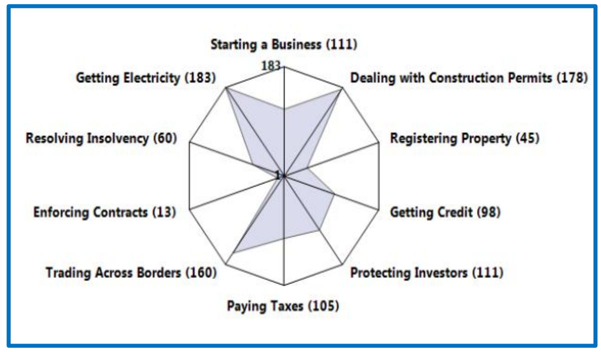
Russia's ranking on IFC's influential *Doing Business Report* has improved from 124 in 2011 to 120 in 2012 out of 183 countries. However, when compared to the rest of BICs, as well as other economies at the same level of development, Russia's performance is mediocre. (IFC, 2012) Figure 4 demonstrates Russia's advancement towards the best practices frontier, which IFC defines as "synthetic measure based on the most efficient practice or highest score observed for each indicator." (IFC, 2011). Though Russia ranks in the bottom third, the progress the country has made since 2005 is quite impressive and the overall trend is encouraging.

Figure 4. Distance to Frontier, 2005-2011



Source: IFC, 2012

Figure 5. Ease of Doing Business in Russia



Source: IFC, 2012

Burdensome regulations are negatively impacting Russia's business environment. It takes 281 days, on average, to get all the necessary approvals and connect a business to the electric grid, and, in IFC's assessment, there is no place in the world where the situation is more dire. (IFC, 2012) As Figure 5 shows, getting electricity, dealing with construction permits and trading across borders remain the weaker spots. On the positive side, Russia scores better than its overall country rank of 120 on the indicators that are more pertinent to the financial services industry, such as enforcement of contracts, getting credit, protecting investors, paying taxes, and resolving insolvency. (IFC, 2011)

2.3.5 Microeconomic Competitiveness: State of Cluster Development

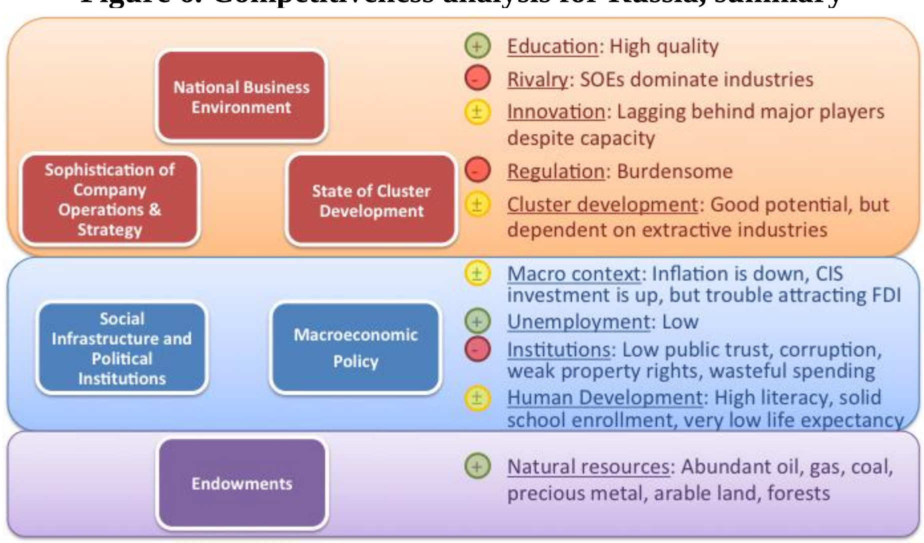
The Russian economy is fairly undiversified with resource industries dominating exports (oil, gas and fuel comprised 69% of Russian exports). Clusters are shallow and employment is skewed towards tradable manufacturing and resource extraction compared to supporting services as historically these sectors were emphasized during the communist era. (Porter/Ketels, 2007) The geography of industrial development during the Soviet era also hinders cluster formation, as Russia currently suffers from the problem of so-called "mono-cities" which host one dominant enterprise incapable of forming a cluster around it. The state of cluster development index deteriorated significantly in 2001-2011, with Russia dropping from #35 to #64. (ISC, 2011)

Though cross-national political and economic ties have weakened since the Soviet era, neighboring countries are significant recipients of Russian FDI outflows (Porter/Ketels, 2007). Liberalization of trade inside CIS led turnover to grow 3 times in 2000 - 2010 (EC CIS, 2011). Customs Union between Russia, Belarus, and Kazakhstan, created in 2010, represents even stronger integration commitment. In January 2012, it was transformed into Common Economic Space with free movement of goods, services, capital, and labor.

2.3.6 Microeconomic Competitiveness: Sophistication of Company Operations & Strategy

Due to history of Soviet industrialization and "shock" privatization, large diversified conglomerates formed in Russia, which only recently became more specialized. As such on company operations and strategy dimension Russia ranks 70th in the ISC ranking, well below its 36th place by GDP per capita with positions decreasing 12 places from 2001, particularly in strategy and operational effectiveness. This could also be explained by recent growth of state-owned corporations, which lack focus, enjoy considerable unfair advantages and are perceived as corrupt. According to WEF, Russia ranks worst among BRIC countries on the dominance of state enterprises (WEF 2011). However, while Russia's ISC score on strategy and rivalry stayed flat over the last decade, productivity score has doubled. (ISC 2012)

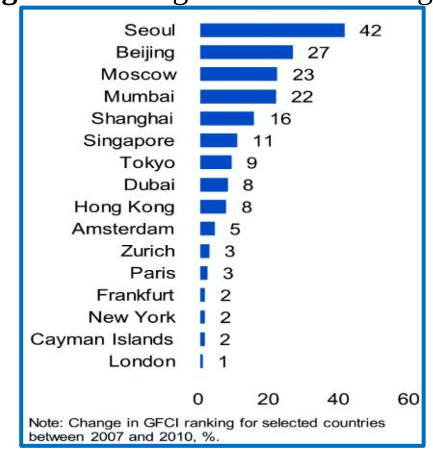
Figure 6. Competitiveness analysis for Russia, summary



3.0 Financial Services Cluster

3.1 Financial Services: Overall Development

Figure 7: Change in GFCI Ranking



Source: City of London, DB Research

The financial sector plays a vital role in the economy because it facilitates capital allocation by providing financing and investment opportunities and risk management solutions to both population and businesses. It also facilitates transactions by providing cash management and payment services. Despite the fast growth the Russian financial sector, it is still considered relatively weak compared to other emerging and developed economies. For example, the most recent World Economic Forum report gives Russia a score of 3.2 on the financial markets development pillar compared to 4.6 for both OECD average and BIC average (WEF 2011). The report emphasized specific weaknesses in ease of access to loans, venture capital availability, legal rights, and financing through local equity market. (WEF 2011)

The financial sector's relative importance in economy and international trade corresponds with the level of development. According to Rosstat financial services, value-added composed only 0.6% of Russian GDP in 2010 (FSSS 2012), and their share of exports was 0.4%[1] (WTO 2012) To analyze the reasons for such underperformance and make recommendations for improvement we will look at its history, location, and subsectors as well as apply the Diamond Model.

3.2. Cluster location: Moscow

Moscow, the capital of Russia, is the 5th largest city in the world with a population of 11.5 million (PWC 2011). Moscow accounts for 22% of Russia's total GDP with a GDP per capita of about $24,000, similar to the levels of other developed countries (FSSS 2012). Moscow is a

[1] Exports in financial services include insurance services .

political, business, educational, and cultural center. As Russia's political center, it hosts the President Administration, the Government and the Parliament. Moscow contains the headquarters of many of the largest Russian companies and has the highest concentration of billionaires in the world. Most of Russia's best universities, including all of its top ten universities are in Moscow (Forbes.ru 2010). It is also the dominant transportation hub due to the legacy of Soviet centralization.

Internationally Moscow is considered by PWC as one of the 26 "cities of opportunities" but ranks 21st overall (PWC, 2011). While it ranks in the middle for intellectual capital and innovation, technology readiness, economic clout and transport infrastructure it is in the bottom 3 for: ease of doing business, health, safety and security, living costs, sustainability and livability (PWC, 2011).

Moscow is also the main financial hub of Russia, hosting 58% of all Russian banks and 86% of large banks, with registered capital over 10 billion rubles (CBR, 2012), the dominant Russian stock exchange, as well as most of the fund managers and investment banks, including country offices of global players. A significant number of leading international and domestic banks are also headquartered in Moscow.

Based on the recent surveys, Moscow is ranked 35th out of 45 global financial centers according to Xinhua-Dow Jones International Financial Center Development Index, and is ranked 65th out of 77 according to Global Financial Centers Index (GFCI). Despite low ranking positions in the ratings, Moscow is gaining a competitive advantage over key financial centers in emerging markets. According to DB Research outlines, Moscow improved its competitiveness in GFCI rating by 23% since 2007, behind only after Seoul and Beijing (see Figure 7).

3.3 History of the Russian Financial Sector

Early stages: The Russian banking system derives from the Soviet Union, where the state exerted total control of capital flows. After the collapse of the USSR and formation of modern Russia in 1991, there was a steep increase in the number of financial institutions. The capital markets were driven by extensive government borrowing and voucher privatization, which paved the way for creation of financial market infrastructure, including several exchanges and many private banks.

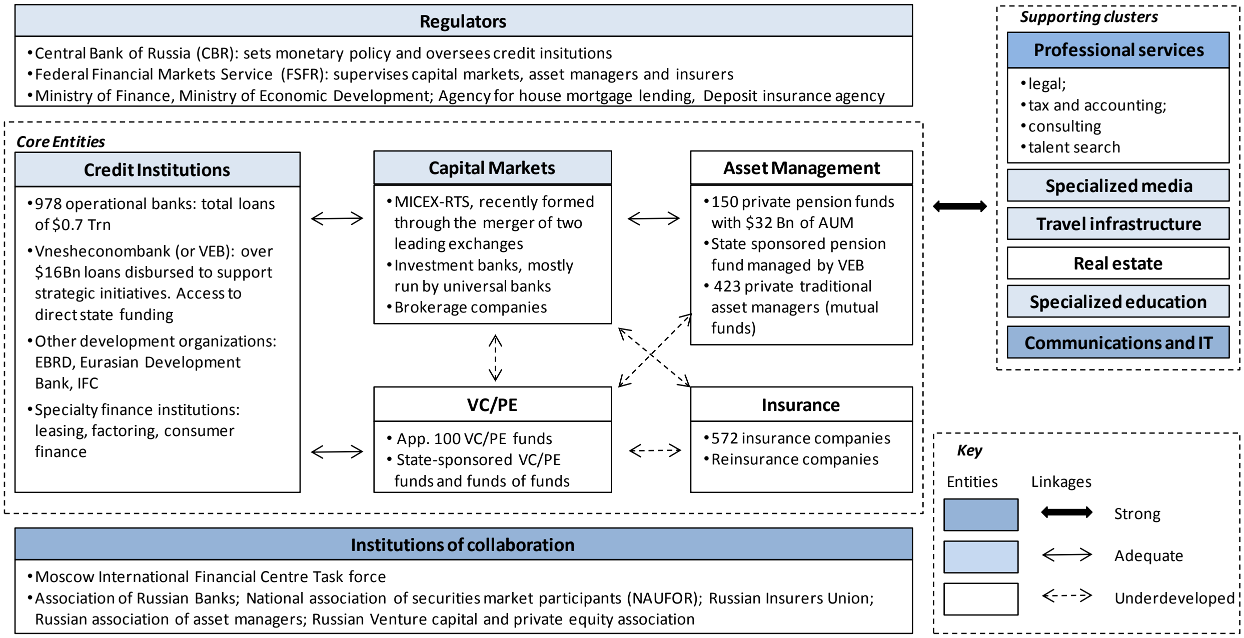
Financial Crisis: Russia's Financial Crisis of 1998, when government defaulted on debt obligations and dramatically devalued currency, set back the development of the financial system and led to the collapse of a considerable number of commercial banks and other financial institutions, including some of the largest private banks. It took until 2001 for the financial system to fully recovered only, with state-owned banks in a much stronger position vs. the surviving private sector players.

Post-crisis development: From 2001-2009, the financial sector was undergoing rapid development driven by real GDP growth, real exchange rate appreciation and growth in the valuation of Russian companies, all underpinned by favorable commodity prices and political stability. The growth was concentrated in relatively short-term lending and equity investments, perhaps reflecting a general lack of trust in institutions. The 2008-2009 financial crisis was acute; the market lost three-quarters of capitalization. However, the system quickly recovered after the government pledged to support the financial system in the form of expanded liquidity for banks and an injection of the state budget capital to the markets.

3.4 Mapping the Cluster

At the core of the cluster there are five sectors: Capital Markets, Credit Institutions, Venture Capital/Private Equity, Pension Funds and Asset Management, and Insurance.

Figure 8. Cluster Map



Capital Markets are at the center of the cluster. They connect all other cluster sectors together as well as provide financing, hedging and investment opportunities directly to the economy. The sector is moderately developed.

Credit Institutions are the largest part of the financial system and primary means of financing for Russian companies. They increase the supply of money by taking deposits and providing loans. Russia's credit institutions are moderately developed.

The **Venture Capital /Private Equity** (VC/PE) sector provides highly sophisticated risk capital for businesses, as well as investment opportunities for institutional investors which are loosely correlated with the capital markets. VC/PE is critical for innovation and important for improving efficiency of existing businesses. Russia's VC/PE is underdeveloped, however recent direct state involvement is expanding the sector.

The **Pension Funds and Asset Management** sector collects voluntary and mandatory savings of various populations and manages them mostly through investing in equity and debt securities through capital markets. These tend to provide higher rewards but also higher risks than bank deposits. Alongside insurance, it is the main provider of long-term capital but it is significantly underdeveloped.

Insurance provides risk management to businesses and individuals by aggregating their risks. Life insurance also has a significant component of a pension plan since the contributions made by individuals are typically accumulated over a long period of time. Non-life insurance (property and casualty, liability etc.) does not have the pension component and does not create long-term investment capital, as the contracts are typically short term. Life insurance is almost non-existent while non-life insurance is underdeveloped.

The overall cluster is characterized by low levels of internal linkages and collaborations, which might be to a large extent attributed to underdeveloped asset management and insurance, and hence their inadequate provision of stable non-levered long-term capital. For example:

- Russian banks make limited use of capital markets to raise equity or long-term debt financing. Very few are listed on Russian stock exchanges. Many use Eurobonds placed with investors through London as a source of long-term capital, especially in foreign currency.
- VC/PE firms rarely acquire funding from local institutional investors (pension funds and insurance companies). Instead they acquire financing from private individuals or foreign capital markets.
- VC/PE firms very rarely exit their investments via IPOs on Russian exchanges. Instead exits are accomplished via trade sales and sometimes IPOs on other exchanges.

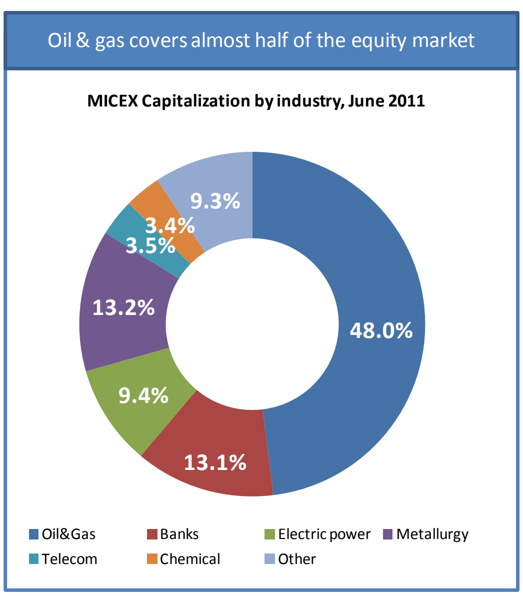
Regulation of the sector is critical. The primary regulatory authorities are the Central Bank of Russia, which is responsible for the credit institutions, and the Federal Financial Markets Service, which oversees capital markets, asset managers and pension funds, and, since March 2011, insurers. Regulation is comprehensive and proved capable of stemming a major financial meltdown during the financial crisis. However, it largely relies on mechanistic rules as opposed to judgment of the regulators.

Collaboration in the sector is strong with one or multiple professional associations in all sectors. Additionally, an overarching collaboration initiative was launched by the President of Russia to develop Moscow in an International Financial Center.

3.4.1 Capital Markets

Equities: Russia's capital markets are predominantly equity based, with most of market capitalization and trading volumes concentrated in a few state-owned and/or resource-orientated companies. Trading is also heavily concentrated in blue-chip stocks, with top companies accounting for 95% of turnover in 2010, which is much higher than for competing financial centers (WFE, 2012). The number of listed companies is modest at 243, as compared to 381 in San Paolo, 584 in Warsaw, and over 1000 in Hong-Kong and India (WFE, 2012). This can be partly explained by the dominance of large resource companies (the oil and gas sector accounted for 48% of MICEX capitalization as of June 2011, and metallurgy account for 13.2% (quote.rbc.ru 2011) and state-affiliated enterprises (52% of MICEX capitalization as of 1Q2012 (MICEX RTS, 2012). Absolute figures for both market capitalization and turnover are also much below key BRIC exchanges. (WFE 2012) (see Appendix for detailed information)

Figure 9. Composition of Russian Equity Markets



Major players are SOEs or state-affiliated companies

Company	Industry	Share of market cap
Gazprom	Oil & gas	17%
Rosneft	Oil & gas	9%
Sberbank	Bank	7%
Lukoil	Oil & gas	6%
TNK-BP Holding	Oil & gas	5%
Novatek	Oil & gas	5%
Norilsky Nickel	Mining	4%
state-owned or -affiliated	**Total:**	**52%**

Sources: quote.rbc.ru ,2012; MICEX RTS, 2012

Bond Markets: Russian bond markets are considerably underdeveloped. The domestic bond market is very small, due to scarcity of federal and state debt instruments. In 2010, the total size of the local bond market was $58 billion compared to $3 trillion for China, $1.3 trillion for Brazil and $707 billion for India. Russia is #2 in international bond with $159 billion outstanding, making it the only country with international bonds amount greater than domestic amount. (TheCityUK, 2011) That companies and banks bypass the local financial sector in favor of foreign investors indicates the weakness of the Russian financial system and capital markets.

Derivatives: On the derivatives market, trading is only active in stock and currency futures, while there was limited activity in options, or in interest rate or commodity futures. Even so the number of transactions on exchanges grew very rapidly, making Russia #4 market of the major emerging economies, not that far behind China and Brazil. (TheCitiUK, 2011)

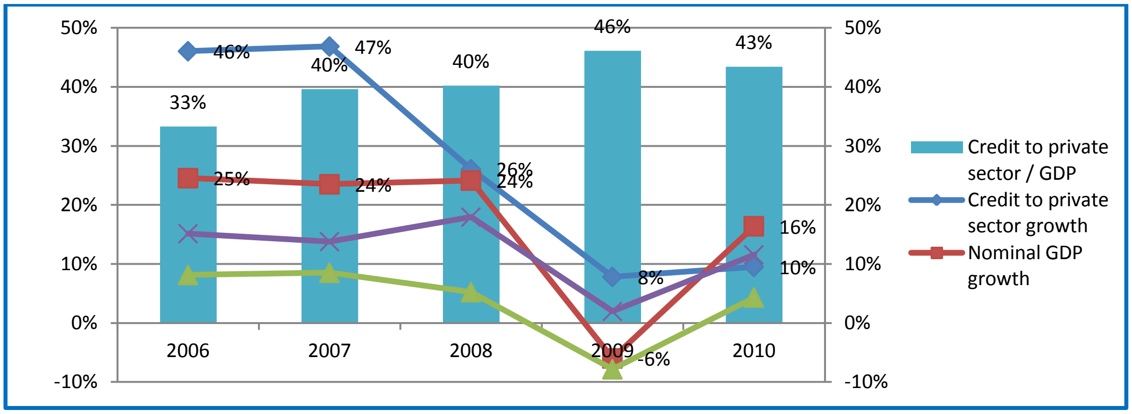
Expansion in CIS and CEE Countries: The reach of Russian capital markets into the CIS countries has been limited. While Russian investment banks are naturally active in CIS countries, and Moscow offices of international firms often play crucial roles in servicing clients from neighboring countries, there are no CIS company listed on Russian exchanges. Instead successful companies from the CIS prefer to list in London or Warsaw (Bloom, 2011).

Relations with Resource Industries: While resource companies account for the majority of the capitalization, they also often bypass Russian capital markets to satisfy their capital needs. For example, from 2005 until October, 2011, only 3 of 7 IPOs in the mining sector were conducted in Russia. None of the 11 IPOs in the oil and gas sector or 7 in metals were conducted in Russia (PWC, 2011)

3.4.2 Credit System

In 2010 Russian banking system had assets of $652 Billion - more than triple its 2005 level– making it the fourth largest and the fastest growing among major emerging markets. However, the growth was largely achieved through nominal GDP increase, including real GDP growth and inflation, which in the absence of nominal currency depreciation drove fast real exchange rate appreciation for ruble. As such banking assets to GDP ratio remained low at 45%, the second lowest among the major emerging economies.

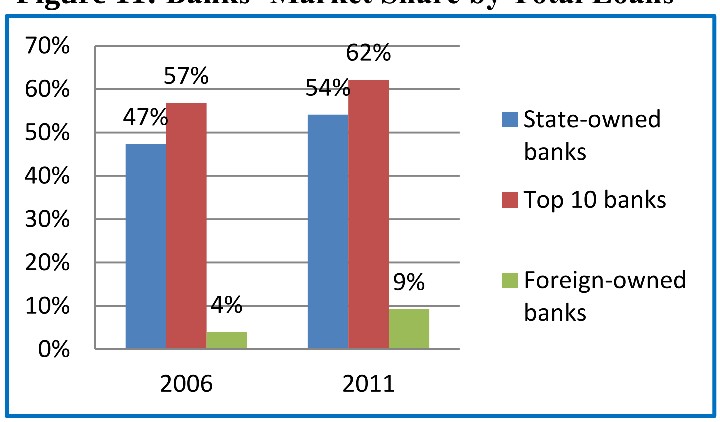
Figure 10: Credit to Private Sector vs. GDP Growth, 2006-2010



Sources: Central Bank of Russia; FSSS; authors' calculation

Composition and Structure: Due to historical ease of launching a bank, the Russian credit system has very large number of banks, albeit with numbers decreasing fast since the 1998 financial crisis, from 2124 registered banks in 2000 to 1112 in 2011 (CBR 2012). Many banks are captive to a single industrial group; some are serving mostly money laundering purposes.

Figure 11: Banks' Market Share by Total Loans



Source: Authors' calculations; Raiting.rbc.ru (2012)

Despite such a large number of banks, competition is somewhat limited due to the presence of very large state-owned banks, especially Sberbank, a successor to the Soviet Savings Banks, which accounts for 34% of loans. (rating.rbc.ru, 2012) The biggest private bank, Alfa Bank is only #4 and has 3% share of loans. (raing.rbc.ru, 2012) The banking system is becoming increasingly concentrated due to consolidation driven by state-owned banks, foreign-owned banks and, to a lesser extent, large private sector players.

With significant support from the government and the central bank the system withered the crisis fairly well and currently Russian banks seem sound based on most indicators (see Appendix – Russian banking sector soundness indicators). Despite this the perception of soundness of banks by business executives, as reported by World Economic Forum is negative, with a score of 3.8 vs. 5.2 for OECD and 5.4 for BIC (WEF, 2012). It might be so because of large unreported risks, especially connected with related party lending and high systemic risk of the largest state-owned institutions – which was partially demonstrated by the emergency rescue of Bank of Moscow (IMF, 2011).

Expansion in CIS & CEE: Russian banks have been active in the former USSR countries, providing cross-border financing to companies, as well as establishing subsidiaries in these countries. In Ukraine, the largest CIS market after Russia, 9 Russian banks had 15.5% of total banking system (Minfin.com.ua 2012). This followed an aggressive credit expansion in 2011, when European-owned banks were scaling down their operations. Russian banks also have some presence in Kazakhstan with about 4% of total assets (prodengi.kz, 2011), as well as in Belarus, Armenia and Azerbaijan.

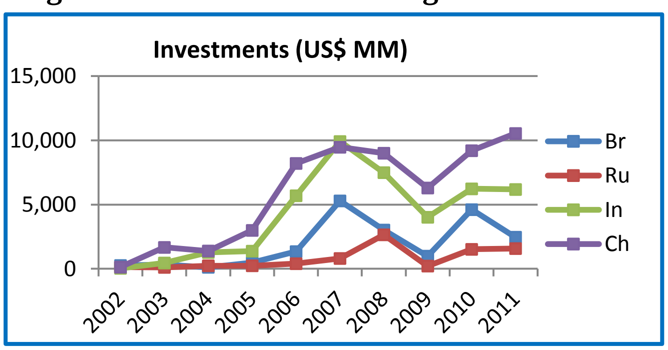
The Central and Eastern Europe region was much less covered however with the acquisition of a sizeable regional player Volksbank by Sberbank in February 2012 Russian banks will have a strong platform for expansion in the region. Additionally, Russian banks increased direct lending to the CIS countries from 2007 to 2010, and the total holding of CIS assets surpassed $7 billion in 2010 (IFM, 2011).

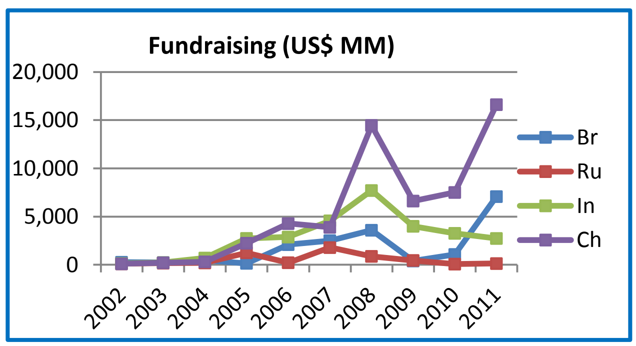
Relations with Resource Industries: Anecdotal evidence suggests that Russian credit system is not always adequate for the needs of Russian resource companies and the large projects they are carrying out. For example the companies constructing the East Siberia Pacific Ocean pipeline Russian oil received a $25 billion loan from Chinese banks. The project finance industry, which would be expected to be strong given the large amount of infrastructure projects and resource exploration undertakings, is in fact underdeveloped. Instead, projects are regularly financed from abroad or directly from the state budget.

3.4.3 Venture Capital and Private Equity

The Russian Venture Capital and Private Equity industry was formed mostly during the 2000s through the slow institutionalization of investments made by high-net-worth individuals and industrial and banking groups, as well as active involvement by the government. Unlike other BRIC markets, international players decided not to enter the market, with only Texas Pacific Group currently maintaining an office in Moscow. The majority of investments are at the venture and growth stage, with leveraged buy-outs almost non-existent. According to the international statistics from Emerging Markets Private Equity Association, both the level of investments and the level of fundraising lags significantly behind other BRIC countries, despite similar starting point in the early 2000s (EMPE, 2012).

Figure 12: VC/PE Fundraising and Investments in BRIC Countries





Source: EMPEA, 2012

Most of the sources for both capital raised and capital invested by VC/PE industry in Russia are local. In 2011, formed funds raised $1.1 billion raised ($3.4 billion of commitments)

(Preqveca, 2012) and there was $4.7 billion capital invested (RWM Capital 2012), which is still significantly underperforming other BRIC countries.

To boost the sector and provide risk capital for the economy, the Russian government chose to intervene directly and set up a number of state-sponsored entities, including:

- **Russian Venture Company**: Launched in 2006 to provide cheap capital to private VC firms. Allocated approximately half of its **$1 billion** to VC funds, including to 100% subsidiaries and some funds started by state-owned companies.
- **Russian Corporation of Nanotechnologies:** Launched in 2008 and allocated **$5 billion** to co-invest in nanotech projects alongside other investors (state-owned, private or foreign companies, banks or VCs).
- **Russian Direct Investments Fund:** Launched in 2011 with the promised allocation of **$10 billion** to co-invest with large global funds and corporations in Russian buyouts and growth capital.

Additionally, there are funds launched by major state banks (VTB Capital, Sberbank Capital), which are among the most active players in the field. It remains to be seen if such an active involvement by the state will prove beneficial for the sector or will distort resource allocation and talent markets, crowding out existing and potential private and foreign players.

Expansion in CIS: While there is little data on investments by Russian private equity firms in CIS, from anecdotal evidence they have an opportunistic approach to investing in other CIS countries, and international funds with offices in Moscow rely on their Russian office expertise when sourcing and executing deals in the CIS.

Relations with Resource Industries: The VC/PE sector is largely irrelevant for resource companies as its financial resources are too limited to undertake major investments in such a capital intensive sector. However, some niche areas and value chain companies benefit from sector growth (as evidenced from an investment in oil and gas equipment manufacturer Novomet-Perm from Rusnano, Barring Vostok and Russia Partners).

3.4.5 Pension System and Asset Management

Pension System: At less than 4% of GDP, assets of Russian pension system are very small. The ratio is higher than in China and India (both less than 1%), but low compared to most other developed and developing markets: 73% of GDP in USA, 35% in Hong Kong, 14% in Brazil. (OECD, 2011) Mandatory and voluntary pension contributions are regulated differently. By default, unless the citizen gives instructions to the Pension Fund of Russia about another type of investment, mandatory contributions are under the management of State Management Company (Vnesheconombank, VEB). As a result, VEB enjoys a dominant position in the market with 54% of total pension savings. Voluntary pension contributions are managed by private pension funds or asset manager specified by the pensioners. Mandatory pension savings constitute some 70% of total savings in the pension system. As of September, 2011, there were $49 billion in mandatory savings and $21 billion in voluntary savings. (Investfunds, 2012)

The state offers a program of pensions co-financing for additional pension contributions. The program has three sides: a citizen, the state (doubles the amount up to a certain limit) and the employer (receives a tax deduction for pension co-financing up to some limit). In terms of funds allocation, the pension system is dominated by government bonds at 46% of total funds and corporate bonds at 27%. Equities only represent around 4% of overall portfolio. (Expert.ru, 2011; NAML, 2012) Such low allocation to equities compares poorly with both developed economies (US – 45%; Canada – 34%), and other developing countries in the region (Poland – 30%; Turkey – 27%). (OECD, 2010)

In the view of many experts, the low quantitative and qualitative performance of the Russian pension system is directly correlated with its incomplete privatization and the dominance of a state-controlled player (Kraus, 2012)

Asset management: At $4 billion dollars of Net Asset Value (only 0.3% of GDP), Russian mutual funds are practically insignificant, especially compared to other emerging markets where industry is much more developed, such as Brazil ($980 billion), China ($365 billion), and South Africa ($142 billion). (TheCityUK, 2011)

3.4.6. Insurance

The Russian insurance market is underdeveloped and characterized by low levels of capitalization. Penetration – total gross premiums as percent of GDP – is around 2.5%, which is lower than in developed countries (US – 11.4%; Germany – 6.6%), and other developing countries in the region (Poland – 3.8%; Hungary – 3.3%). (OECD, 2012; Expert.ru, 2011). The ratio of total asset in insurance system to total premiums was 0.9x in 2007, while 2.6x in Poland and 2.1x in the US. (Expert.ru, 2011), which reflects the short-term nature of contracts and the dominance of non-life insurance.

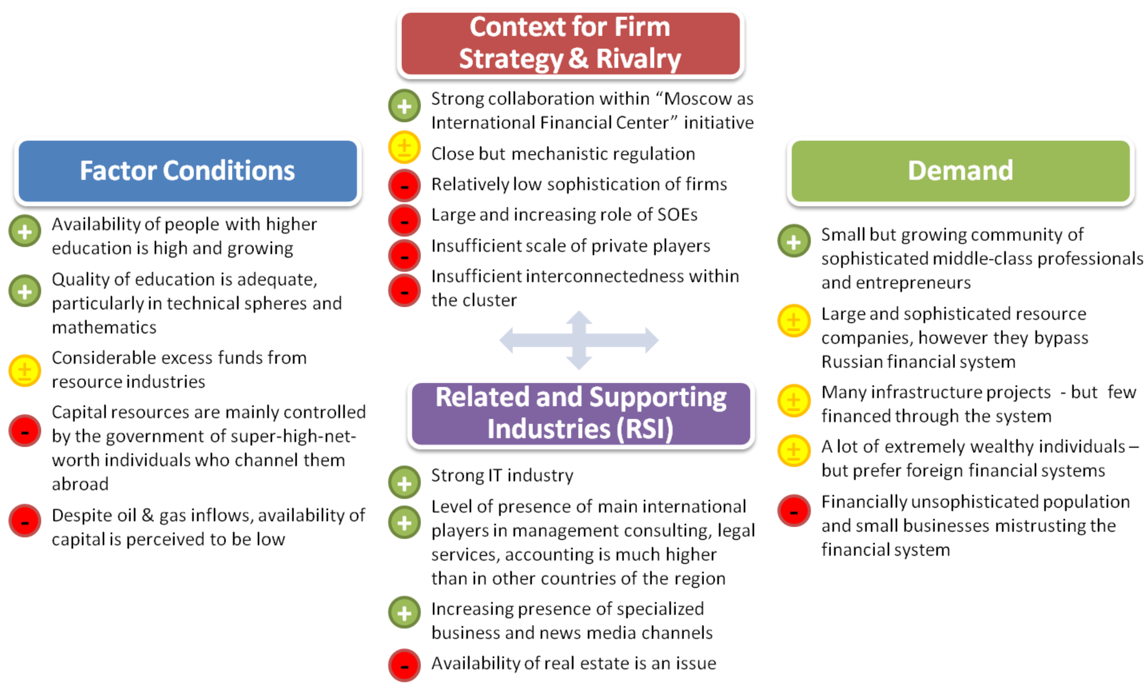
Life insurance is almost non-existent. The share of life insurance in total gross premiums is only 2%, much lower than both developed countries (50% in the US and 42% in Germany) and other developing countries in the region (66% in Poland, and 13% in Turkey). (OECD, 2012; Expert.ru, 2011) Insurance density (total gross premiums per capita) was $291 per capita in 2009. (Expert.ru, 2011)

The industry has recently experienced growing consolidation and decreasing profitability. In 2010, the top 5 players commanded 42% of the market versus 36% in 2008. The number of insurance companies decreased from its peak of 2,800 in 1995 to 600 in 2010. (Expert.ru, 2011) Between 2006 and 2010, the combined ratio increased from 104% to 108% for large federal players and from 95% to 101% for Moscow's medium and small players. (Expert.ru, 2011)

3.5 Diamond Analysis

The cluster enjoys relatively favorable factor conditions with a high savings rate and a historically good education, providing a solid foundation for skilled employees. Related and supporting industries are also fairly developed, at least in the Moscow region. Context for firm strategy and rivalry is much more problematic with dominance of state-affiliated enterprises stifling competition. However, a new collaborative effort could improve the situation. Demand conditions present both a challenge and an opportunity, as there is significant sophisticated demand currently not met by the cluster.

Figure 13. Diamond Analysis of Moscow Financial Services Cluster



3.5.1 Factor Conditions

Key factor inputs for financial services are financial capital and skilled labor There are favorable conditions for **capital** formation since the gross national savings rate is high (25% of GDP in 2010). This is on par with Japan (24%) and Germany (23%), and much higher than the U.S. (13%) and Brazil (17%). (WEO, 2012) However the financial services industry has failed to take advantage of this capital. Indeed, Russia is one of the fifth largest capital exporter in the world (after China, Japan, Germany, and Switzerland), generating around 5% of the world's total net capital outflow. (IMF, 2011) Capital resources are mainly controlled by super-high-net-worth individuals who often channel them abroad for security and tax reasons, and by the government which chooses to invest in foreign securities in order to prevent overheating of domestic economy and avoid excessively fast real exchange rate appreciation.

Turning to **labor**, the availability of highly educated workers is high and growing. In the Moscow labor force, 47% of workers have a higher professional degree and another 28% have secondary professional degree. (Moscow City Government, 2010) The number of students in higher educational institutions per 1,000 people in Moscow grew from 586 in 1990 to 1,149 in 2005. (FSSS, 2012) The share of state-owned universities is gradually shrinking. The perceived quality of education is adequate, particularly in technical spheres and mathematics. However, there is a perceived lack of highest level management talent, such as CEOs for banks.

3.5.2. Related and Supporting Industries

The related and supporting industries are generally well developed. The IT sector is among the fastest growing in Russia with 22-23% growth in 2010-2011. (PMR, 2011) The prevalence of major players in management consulting, legal services, and accounting is much higher than in other countries of the region. Moscow boasts 35 major international law firms, 45 management consultancies, 7 out of the global top 10 real estate services companies. Moscow boasts a number of specialized business and news media channels - RBK, Moscow24, Russia24, Kommersant are among the major national players. However, the availability of real estate is an issue. Moscow has substantial office stock, but lowest per capita usage in Europe. (Jones Lang LaSalle, 2011)

3.5.3. Context for Firm Strategy and Rivalry

The **Moscow as an International Financial Center Initiative**, unites key cluster participants from the private sector, as well as regulators and government officials with the aim to implement reforms and promote Moscow as an international financial center. Instituted in 2010, it is headed by the President, with a reputable international advisory board comprised of top managers of global financial institutions and key Russian cluster companies. The initiative has partnered with TheCityUK to transfer knowledge and best practices. A former head of presidential administration led a special taskforce comprised of high-profile market participants, officials, advisors and academics to identify key improvements in the following areas: 1) Financial infrastructure and financial market regulation; 2) Corporate law and governance, financial transaction taxes; 3) Administrative procedures; 4) CIS/Eurasian Economic Community/EEC Customs Union cooperation; 5) Moscow infrastructure development; 6) Education, Health, Culture and Social Infrastructure in Moscow; and 7) Marketing.

The taskforce offered over 100 recommendations, and a number of changes were successfully initiated, including the creation of the Central Depositary, the merger of the two leading Russian exchanges, improvement in shareholder rights and access to information, and a reform of the civil code. The effort is widely praised by cluster participants, but it remains to be seen how it will fare as Putin transitions back into power. However, it is unclear if the initiative is focused enough or has a singular strategy guiding its efforts.

The key weakness in the context for strategy and rivalry is **large and increasing role of SOEs**. They are dominant in the banking, pension funds and VC/PE sectors, and increasingly important in capital markets. An implicit state guarantee helps those enterprises get access to cheaper resources, distorting competitive field, and potentially leading to misallocation of resources. Aggressive state support during the crisis may have produced a moral hazard problem. (IMF 2011) Additionally, with SOEs playing such an important role in the economy in general, they tend to gravitate towards state-affiliated providers of financial services.

SOE dominance weakens the private sector as private firms have difficulties competing with state and foreign firms for the most lucrative clients and projects. The state-owned banking champion is 10 times smaller by total loans than the largest private bank. The state pension provider has over 50% market share and the size of state-sponsored Russian Direct Investments Fund dwarfs any domestic private sector establishment. SOE dominance can push private institutions into niche markets or encourage excessive risk-taking (IMF 2011).

The regulatory environment is mixed. On the positive side, the Central Bank of Russia (CBR) handled the financial crisis fairly well, preventing disorderly failures and bank runs by injection of liquidity and increase of deposit insurance. Banks are adequately capitalized and financially solid, while CBR has good access to information. In addition the recent shift of monetary policy from targeting exchange rate to targeting monetary supply helped decrease inflation and returned real interest rates in the positive domain.

However, regulation is still mechanistic and based on monitoring a limited number of ratios calculated monthly. Regulators rely on local accounting standards for reporting and compliance monitoring, which are easy to manipulate and provide inadequate information for investors. Finally, the Central Bank and FSFR have limited authority to use their judgment and require corrective actions for particular institutions, making the regulation somewhat inflexible and ill-suited for the increasingly complex financial system.

3.5.4. Demand Conditions

Demand for financial services is very idiosyncratic and presents a considerable challenge, as well as significant opportunities. On the corporate level, Russia has a few very large companies in resource sectors, which have significant international operations and vast and sophisticated demands for financial services, including capital raising, credit resources and risk management. However, the domestic financial system cannot fully satisfy those demands, so firms seek capital from international markets instead. For example, Gazprom faced problems when it decided to acquire the controlling stake in the oil company Sibneft. It had to raise $13 billion, which was virtually impossible in the domestic Russian financial system. Instead, they acquired a loan from a syndicate of Western banks. (Filippov, 2010) Similarly, from 2005-2011, Russian stock exchanges were the primary place of listing for only 36 of 104 IPOs of Russian companies. Instead, the destination of choice was the London Stock Exchange with 56 IPOs. (PWC, 2011)

Likewise, Russia has 101 billionaires and accounts for a third of all Europe's 300 billionaires. And among the world's top 100 richest people, there are 15 Russians, more than from Saudi Arabia or all the other BRIC countries combined (mercopress.com, 2011). Yet, there is no thriving private banking or private wealth management industry in Moscow to service the needs of Russian high-net-worth individuals. The problem of the underdeveloped market is compounded by the lack of legal protection for property rights, sometimes exacerbated by the dubious origins of the wealth.

The majority of population, while relatively well-off compared to many other emerging markets, still provides quite unsophisticated demand. Russia lacks a tradition of investments and consumer credit, which were non-existent in the Soviet Union. Moreover, there is a general mistrust in the post-Soviet financial system, exacerbated by the negative impact of hyperinflation in the 1990s and significant losses during the 1998 currency crisis. As a result, a very small percentage of the population purchases life insurance products, invests in mutual funds, has a brokerage account (714,000 or 0.5% of the population in Q4 of 2010, of which approximately 100,000 are active (NAUFOR, 2011)) or has a credit history (14.3% of Russian population in 2009 compared to 59.2% in Brazil (WEF 2011, P53)).

On the positive side, the period of economic growth created a sizeable middle class of professionals and entrepreneurs who are more comfortable with using advanced financial products and have both excess funds to invest and confidence in future earnings to borrow.

4.0 Recommendations

4.1 First Priority Recommendations

1) Develop a strategic positioning for the cluster: For the Russian financial sector to compete efficiently in the global market, key players must develop a clear strategic position. A promising strategy is geographic specialization: **positioning Moscow as a financial center for CIS** (and potentially CEE). This option is attractive since Russian banks, insurance companies and investment firms are already making inroads in CIS countries. Moreover, demand in Russia is more sophisticated than in other CIS countries and there is growing economic and political cooperation. One of the MIFC taskforce groups is explicitly charged with CIS and Eurasian Economic Community cooperation, indicating that this strategy is being actively considered. Key risks for it are external: loss of political and economic influence in the CIS (to EU in the West and China in the East), as well as nationalistic and anti-Russian sentiments.

Another strategy would be customer specialization: positioning Moscow as a **financial center for global resource companies**. While there is considerable demand potential due to presence of large resource companies, Russia will need to grow and consolidate its large players to match the scale of future clients (which may negatively affect already weak competition) and develop trading in commodity derivatives (which is typically done near major consumers of resources, not producers). A third strategy could be **product specialization**, such as long-term bank financing, large-scale infrastructure financing or maritime insurance. However, the development of any globally competitive products in Russia appear unlikely in the near future.

Russia should utilize the platform of the MIFC initiative to stimulate the debate inside the cluster regarding its intended positioning. A cluster-wide agreement on a chosen positioning should allow its participants to focus and develop their strategy upon this choice.

2) Enhance competition: Russia should gradually **privatize state-owned enterprises**, and **break up** some of the largest, oligopolistic entities, such as Sberbank and VTB. Additionally, the state should stimulate **consolidation of private players** to enable competition with SOEs by further raising minimal capital requirements, simplifying takeover procedures and removing barriers to foreign investments.

3) Enhance rule of law and improve business practices: Corruption and legal rights enforcement are pressing problems. Corruption is ranked the biggest impediment to doing business in Russia and increases costs by about 10%, while the perception of legal rights enforcement is dismal at 3.0, compared to 5.7 for BIC and 6.7 for OECD average. (WEF 2011) This is especially problematic for financial intermediation, which requires trust. Russia needs to **vigorously fight corruption** on national and regional levels, through reorganization of police and security services, comprehensive legal reform, decreasing state involvement in the economy, simplifying regulations, increasing salaries of officials, judges and policemen while simultaneously tightening punishment and creating an independent corruption watchdog. Cluster participants can also contribute through joining World Economic Forum's "**Partnering Against Corruption Initiative**" and raising their standards for dealing with "grey area" clients.

A comprehensive **legal reform** is also needed to ensure independence of judges; in the mean time increasing application of foreign arbitrage clauses could be a temporary solution. Additionally, Russia's regulations are more burdensome than almost all its peers, and as such it should streamline existing permit processes, simplify necessary regulations and eliminate obsolete regulations and unnecessary certifications and permits.

4) Develop "long money" sectors of the cluster: With underdeveloped pension sector, asset management and life insurance, the Russian financial system lacks interconnectedness. It relies on services from abroad to provide more complex and long-term financial products. The cluster should stimulate the creation of "long money" through **growth of pension funds, AM and life insurance assets**, as well as allowing and encouraging **more risk-taking in allocation** of these assets (including domestic alternative asset managers and equities). Russia should **privatize pension system**, or at least eliminate the "opt-out" provision to end the unfair advantage of the state-owned player. It is also necessary to **increase financial awareness** of the population and promote the importance of the choice of pension asset manager, including through incentives for employers to do on-the-job seminars and education; social advertising; creating a user-friendly website with information about the level of performance and current offerings of existing pension funds and asset managers; as well as other suggestions from the new MIFC group.

4.2 Second Priority Recommendations

1) Increase sophistication of mass-market demand: Significant proportion of population lacks basic financial knowledge, which is exacerbated by mistrust due to wiping out of savings during the early 90s hyperinflation and in 1998 crisis. Small and medium enterprises also lack sophistication and access to financing. We suggest that a separate **working group should be established within the MIFC initiative** to come up with action plans both for the government (state and regional) and for private sector (which the participants can actually commit themselves to). Such solutions could include:

- Educating public in financial management, including strengthening retail banking and brokerage outside of large urban centers
- Establishing a trusted and accessible consumer financial protection body or promoting this function within existing regulators will help earn trusted of the population

- Launching programs to educate SMEs about available financial options and assisting them with getting access to financing is another suggestion
- Finally, cluster participants should develop simple products tailored for current non-users to involve them into financial system.

2) Gear financial system to satisfy sophisticated demand: Despite Russia being a commodity superpower its financial system cannot provide products to hedge energy or metal prices risks nor finance large-scale projects. To address it Russia needs to **stimulate trading in energy products**, which would be effective only if coupled with true **deregulation of internal energy markets** (electricity, gas, petroleum products). It should also enable and **promote instruments for financing of large scale projects** (syndication, project finance, PPPs etc.), including necessary changes to regulations on collateral management.

To meet the demands of ultra-high-net-worth individuals the sector should **develop private banking and private wealth management** offerings. While addressing rule of law and corruption issues would go a long way towards stemming the capital flight, the government might also provide additional security guarantees and perform a **"tax amnesty"** (however effects on corruption need to be calculated). Cluster participants should learn the needs and requirements of extra-high-net-worth individuals, for example through interviews, and improve the sophistication of existing offerings and provide customized solutions.

In general to increase sophistication it is desirable to invite **more foreign companies** with superior technologies, including potentially allowing opening of branches in Russia for foreign-registered banks and insurance companies at least for limited scope of operations, as well as to **simplify visa and work permit regulations** for highly skilled individuals and actively seek high-quality financial talent. Established cluster players should also consider **acquiring or partnering with foreign companies** to get know-how, and **open offices in advanced markets**.

3) Keep shifting monetary policy towards a floating exchange rate: A considerable part of profits from the resource industries is not channeled through the financial system and instead captured in CBR foreign exchange reserves or in Russia's Sovereign Wealth Fund. This was done to avoid overly rapid exchange rate appreciation and had as a consequence persistently high inflation. As the real exchange rate approaches its parity the CBR should focus more on fighting inflation and satisfying other internal needs of the economy and move to a **more flexible exchange rate** – which would allow lower inflation and better predictability for financial actors. CBR and the government should also encourage **freer rubble convertibility**, and stimulate its **usage in international trade**, especially in the CIS countries. This recommendation would become a first priority if Moscow positions itself as the center for the CIS countries.

4) Increase flexibility of financial regulation: While financial system's rising complexity and interconnectedness increase difficulty in detecting risks, current regulatory system relies largely on mechanistic approaches, which may be inadequate for the system. To enhance the regulatory framework Russian government should **increase cooperation between key regulators** (FSFR and CBR). The regulators should more actively **supplement quantitative data with qualitative judgment** for purposes of oversight and regulation. A faster **adoption of Basel 2 and Basel 3** rules for banks and respective regulations for insurance companies should also be targeted. Additionally, cluster participants should be required to implement (and do so voluntarily if not required) **IFRS accounting standards**.

5) Keep investing in Moscow's infrastructure development: To address Moscow's most pressing problems with livability, health and transportation the city government need to facilitate development of **mid-budget property** while increasing transparency in property deals, invest in **schools, hospitals and daycares**, **road infrastructure** and **parking** facilities; as well as expand **signage in Latin characters** and potentially launch a **tolerance campaign**.

5.0 Disclosures and Appreciations

- One member of the team – Kirill Dushkin – is a Russian national.
- No non-public information has been used in the preparation of this report.
- No member of the team has traveled to Russia during the project period.

In the preparation of this project, the team has conducted interviews with Timothy Krause, Head of Russia Bank Opportunity Fund, International Finance Corporation, and Ekaterina Malofeeva, director of Analytical Center "Forum" and coordinator of the Moscow as International Financial Center initiative, to whom we would like to express our sincere appreciation.

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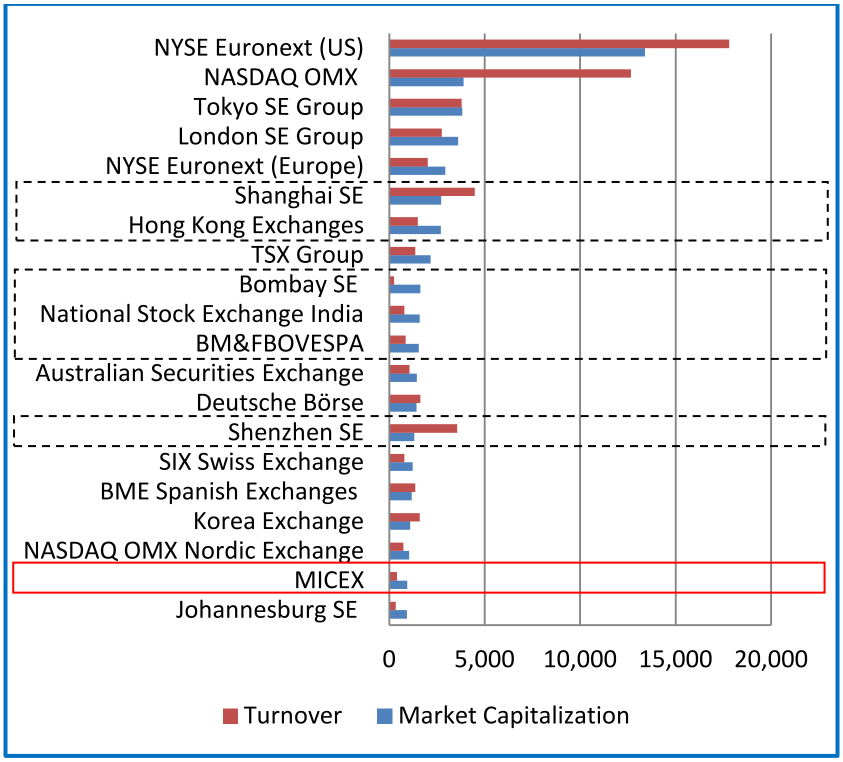
Appendix:

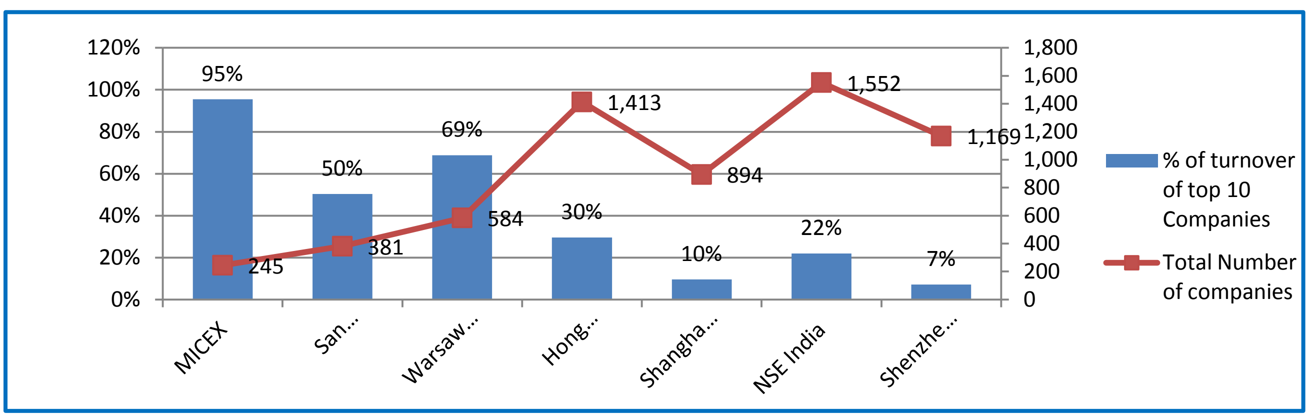
Comparative performance of Russian capital markets

Top 20 Equity exchanges in the world (by total market cap, $ billion)



Sources: World Federation of Exchanges

Key indicators for emerging markets stock exchanges. 2010



Sources: World Federation of Exchanges

Bond market development of key emerging economies

Amounts outstanding, end-year, $bn						
	Domestic bonds			**International bonds**		
	2005	2010	Change, %	2005	2010	Change,%
China	899	2969	230	29	75	157
Brazil	549	1294	136	109	175	61
India	279	707	153	16	50	214
Mexico	271	413	53	89	106	20
Turkey	183	239	30	36	57	59
Malaysia	108	219	103	29	41	42
Thailand	80	218	173	11	10	-8
Poland	105	200	90	33	63	89
South Africa	108	167	55	27	45	65
Indonesia	54	107	100	13	36	171
Venezuela	74	96	29	26	49	85
Hungary	49	80	62	18	36	99
Czech Republic	34	78	131	6	25	311
Egypt	24	78	221	4	8	92
Colombia	41	78	92	14	25	80
Russia	25	58	132	69	159	131
Argentina	72	58	-19	60	54	-10
Other countries	180	405	125	138	353	157

Source: The City UK. Financial Services in Emerging Economies. June 2011. p. 6

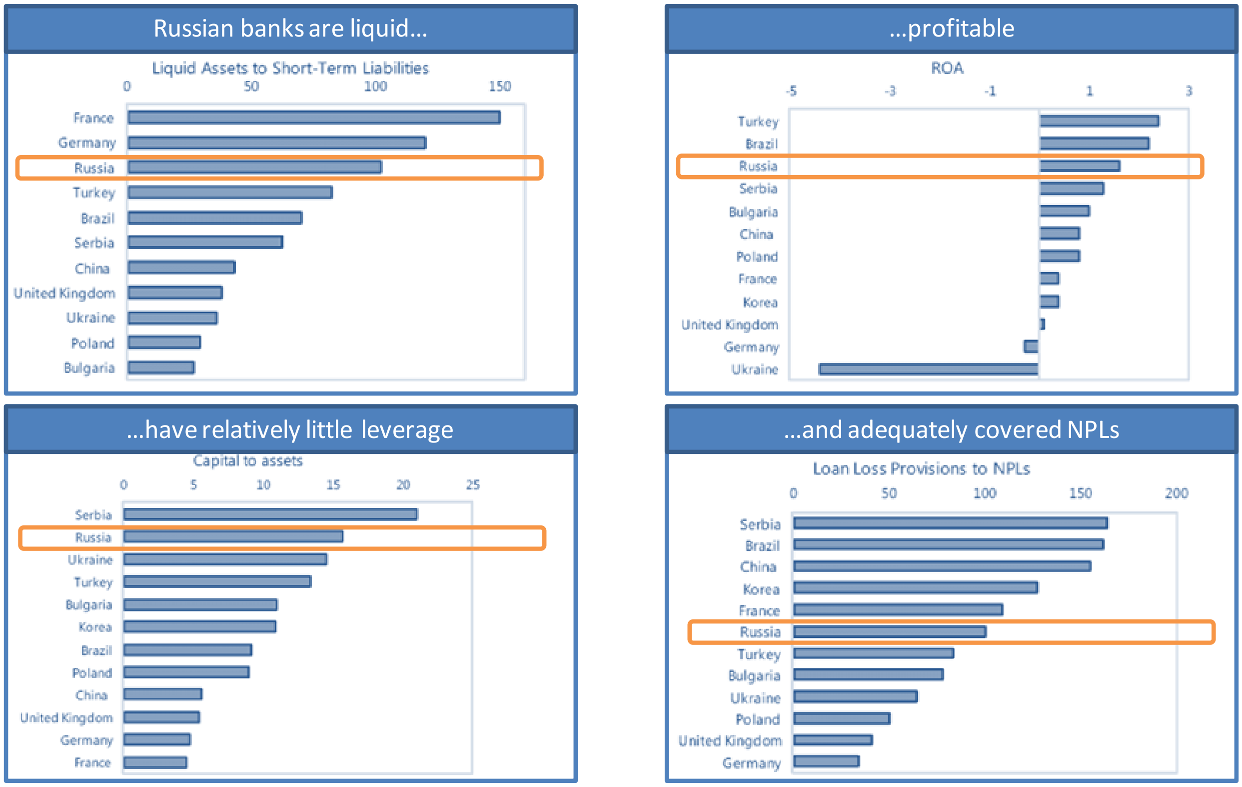
Activity in exchange-traded derivatives

Annual number of transactions, millions				
	India	China	Brazil	Russia
2005	203.7	260.6	466.3	61.2
2006	293.4	224.8	571.1	120.0
2007	483.8	364.2	794.1	229.4
2008	709.1	676.0	741.9	370.1
2009	1333.9	1078.8	920.4	493.7
2010	2737.8	1566.8	1422.1	656.0
05-10 increase, x	13.4	6.0	3.1	10.7

Source: The City UK. Financial Services in Emerging Economies. June 2011. p. 8

Russian banks' soundness

Indicators of Russian banks' soundness



Source: IMF. Russian Federation 2011 Article IV consultation. September 2011. P27